IN THE COURT OF APPEALS OF TENNESSEE
AT KNOXVILLE
November 4, 2009 Session

LONE STAR OIL & GAS, INC. v. ELMER C. HOWARD, ET AL.

Appeal from the Chancery Court for Morgan County
No. 07-63 Frank Williams, Chancellor

No. E2009-00428-COA-R3-CV - FILED FEBRUARY 12, 2010

Lessee filed a declaratory action to interpret an Oil and Gas Lease ("the Lease") after Lessor denied access to the property. Upon concluding that the Lease terminated by its own terms, the trial court denied relief to Lessee. Lessee appeals. We affirm.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Affirmed; Case Remanded

JOHN W. MCCLARTY, J., delivered the opinion of the Court, in which HERSCHEL P. FRANKS, P.J., and CHARLES D. SUSANO, JR., J., joined.

John P. Williams, Nashville, Tennessee, for the appellant, Lone Star Oil & Gas, Inc.

Phillips M. Smalling, Byrdstown, Tennessee, for the appellee, Elmer C. Howard.

OPINION

FACTUAL BACKGROUND

Lone Star Oil & Gas, Inc. ("Lessee") entered the Lease with Elmer C. Howard ("Lessor") on August 30, 2004. The Lease permitted Lessee to build wells on Lessor's property for the purpose of extracting oil and natural gas.

In 2004, Lessee acquired six oil and gas leases from Pryor Oil Company, and one of the six leases included a lease with Lessor that was executed in 2001. Soon after, Lessee executed its own lease with Lessor. Under the terms of the Lease, Lessor provided 248 acres

to Lessee. Lessee constructed a well on Lessor's property and extracted gas through the well.[1]

Until August 2006, the well produced gas. Citizens Gas paid royalties for the gas to Lessee, Lessor, and the Whites. Because Citizens Gas encountered problems extracting gas from the well, the company sent the last royalty check on October 30, 2006.

The Lease provided for a primary term of one month and then a continuation,

> "for so long thereafter as oil, gas, or either of them is produced from the leased premises."

In August 2006, Citizens Gas's problems with extracting gas from the well were due to a problem with its compressors. The well was characterized as a shut-in. Throughout the remainder of 2006, the well did not produce gas, and no royalty payments were made. If Lessee wanted to extend the Lease beyond the primary term of one month, the Lease required Lessee to make shut-in royalty payments to Lessor after the well became shut-in.

On January 1, 2007, Lessor denied access to the well because he believed that the Lease had terminated. On February 19, 2007, Lessee sent a letter and check for $815 to Lessor. The letter stated that the gas well had not been in production for five months, and the check was for Lessee's obligation to pay the "shut-in royalty." Lessee determined the amount of $815 based on what Lessor would have received if production had continued. Lessee claims that Lessor never sent a written notice informing Lessee that it was in default under the Lease. Nonetheless, Lessor returned the check to Lessee and continued to deny Lessee access to the property.

In early 2007, a Canadian company, Montello Resources ("Montello") contacted Lessee and expressed interest in a joint venture to drill on Lessor's property. After a meeting among Lessee, Montello, and Lessor, Montello ceased communications with Lessee. Eventually, Lessor executed a lease with Montello for the same tract of land covered by the Lease with Lessee.

Lessee filed a Complaint on June 8, 2007, seeking a declaratory judgment. The Complaint alleged that the Lease was in effect and Lessor denied access to the property. In

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[1]Thomas White and Pamela White (collectively "the Whites") own a tract of land adjacent to Lessor's property, and a portion of the gas extracted through the well at issue comes from the Whites' property. The trial court required, sua sponte, that the Whites be named as parties because the well was a unit production well.

his Answer, Lessor asserted that the Lease expired by its own terms and that written notice of default was not required by the language of the Lease.

The case was eventually tried in January 2009, and the trial court, sitting without a jury, denied the relief sought by Lessee and held that the Lease terminated by its own terms. This appeal ensued.

ISSUE PRESENTED

Whether the trial court erred by holding that the Lease terminated by its own terms.

STANDARD OF REVIEW

On appeal, the findings of fact of a trial court sitting without a jury are reviewed de novo with a presumption of correctness. Tenn. R. App. P. 13. This court will not disturb the trial court's findings of fact "unless the preponderance of the evidence is otherwise." *Id.* However, the trial court's conclusions of law are reviewed de novo with no presumption of correctness. *Ganzevoort v. Russell*, 949 S.W.2d 293, 296 (Tenn. 1997).

The construction of a contract or other written instrument is a question of law. *Toomey v. Atyoe*, 32 S.W. 254, 256 (Tenn. 1895). Ascertaining the intention of the parties to a written contract is a question of law rather than a question of fact. *Hamblen County v. City of Morristown*, 656 S.W.2d 331, 335-36 (Tenn. 1983).

DISCUSSION

Lessee challenges the trial court's holding that the Lease terminated by its own terms. Lessee contends that because Lessor failed to give Lessee written notice of default under the terms of the Lease, the Lease was still in effect. Lessee points to paragraph six of the Lease in support of this assertion.[2]

According to Lessee, Lessor did not comply with the Lease's notice requirements, and

[2] 6. ASSIGNMENTS: Rights of either party hereunder may be assigned but no assignment shall increase or diminish such rights. Provisions herein are binding on heirs, successors and assigns of the parties. Lessors shall make no claim of default against Lessees or their assigns until Lessors, or their assigns, first notify the Lessees herein of such claim and unless such default is not cured within 10 days after notice. Notice of default is effective when delivered or placed in the U.S. Mail, certified, addressed to the Lessees named herein at.

he was not entitled to deny access to the property. Lessee cites *Tennessee Valley Kaolin Corp. v. Perry*, 526 S.W.2d 488 (Tenn. Ct. App. 1975). In *Perry*, the lessee failed to make the minimum payments to the lessor for four years, but the lessor failed to give notice of non-payment to the lessee, as required by the mineral lease. *Id.* at 489-90. The court held that there was no forfeiture of the lease because the lessor failed to comply with the notice requirement. In upholding the notice provision, the court stated:

> All that is required of the lessors under the notice provision is that they give written notice of default within 30 days thereof. Then, if the lessee does not rectify the default within 60 days from that default, the lessor has the right to terminate.

Id. at 492. Lessee claims that it relied on the notice provision of the Lease. Because Lessor did not give notice of default, he did not have the right to terminate the Lease.

In response, Lessor contends that he did not have to give Lessee notice of default because the Lease had expired by its own terms. The Lease provided that its primary term was for one month so long as oil or gas was produced from the well.[3] Because of the Lease's primary term of one month, Lessor asserts that Lessee's rights terminated when gas production ceased in August 2006. It is irrelevant when the royalty checks were tendered to Lessor because the Lease term was conditioned on production, not date of payment.

An oil and gas lease, as any other contract, is interpreted using the rules of construction. *See Waddle v. Lucky Strike Oil Co.,* 551 S.W.2d 323, 326-27 (Tenn. 1977). A lease should be considered in its entirety, and it is construed according to the plain meaning of the language used unless the language is ambiguous. *Cali-Ken Petroleum Co., v. Slaven*, 754 S.W.2d 64, 65 (Tenn. Ct. App. 1988). ". . . [T]he court seeks to ascertain the intention of the parties from the language used." *Waddle*, 551 S.W.2d at 326. Nonetheless ". . .if disputed language in a contract is ambiguous, or uncertain, it will be construed most strong against the author." *Dunn v. United Sierra Corp.*, 612 S.W.2d 470, 473 (Tenn. Ct. App. 1980).

In *Waddle*, the Tennessee Supreme Court resolved a dispute over the interpretation of an oil lease. 551 S.W.2d at 323. The lessee argued that the lease was still in effect because the lessor did not comply with the forfeiture clause that provided to the lessee the opportunity to cure a default. *Id.* at 327. The lessee claimed that the provision excused its obligation to drill or pay rentals. *Id.* The Court reasoned that this type of opportunity to cure

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[3] 1. PRIMARY TERM: This lease is for the term of one (1) month and for so long thereafter as oil, gas, or either of them is produced from the leased premises.

provision had nothing to do with the lessee's obligation to "drill or pay delay rental." *Id.* As explained by the Court,

> We conclude that this lease required lessee to drill, to pay delay rental, or to be in production in paying quantities on the 'rental paying date[s],' or the lease terminated by its own terms.

Id. Encouraging the diligent operation of a well is one of the purposes of an oil and gas lease. *See id.* at 326; *Slaven*, 754 S.W.2d at 65; *Young v. Dixie Oil Co.*, 647 S.W.2d 235, 237 (Tenn. Ct. App. 1982). "Therefore such a lease or option is properly construed against the lessee, so as to secure such speedy development." *Waddle*, 551 S.W.2d at 326 (citing *Mountain States Oil Corp. v. Sandoval*, 125 P.2d 964, 967 (Colo. 1942)).

Similar to the result reached in *Waddle*, we find the Lease at issue in this case terminated by its own terms. Lessee's reliance on *Tennessee Valley Kaolin Corp. v. Perry* is misplaced. First, the lease at issue in *Perry* was for a 30-year period. 526 S.W.2d at 489. Second, the lessee agreed to pay a guaranteed minimum annual payment. *Id.* The *Perry* court observed that ". . .an implied duty to mine can be and is waived by the lessor 'where the lessee has paid or agreed to pay a specific sum of money in lieu of recurring royalties and the money has been accepted by the lessor.'" *Id.* at 491. In the case at bar, the Lease did not provide for a guaranteed minimum annual payment. Therefore, the *Perry* holding offers little guidance to the issues of this case.

Contrary to Lessee's assertion, Lessor's obligations under the notice of default provision were independent of Lessee's obligations to be in production, pay royalties or rentals. *See Waddle*, 551 S.W.2d at 327. The language of a lease controls the duration of the interests granted. *See P.M. Drilling, Inc. v. Groce*, 792 S.W.2d 717, 721 (Tenn. Ct. App. 1990). Discussing the Lease's primary term of one month, the trial court noted:

> . . .[Y]ou can hold over from month to month after the expiration of the primary term provided that you're [Lessee] performing and have performed everything that you're supposed to have performed during that primary term.

The trial court's observation properly frames the issue: the Lease provided that nonperformance of certain conditions would warrant termination. As the *Waddle* court explained "if the conditions expressly provided to avoid termination are not performed, then termination is the result. . . ." 551 S.W.2d at 327. Therefore, Lessee's failure to produce oil or gas from the well or tender rental or royalty payments to Lessor for four months led to the termination of the Lease by its own terms. Lessee's right to notice of default expired once the Lease lapsed.

Even assuming *arguendo* that the notice provision was in effect, as Lessee asserts, the inartful drafting of the Lease excused Lessor from providing written notice of default as stated in paragraph six of the Lease. Because we construe ambiguity in contracts against the drafter, *see Dunn*, 612 S.W.2d at 473, which in this case is Lessee,[4] we agree with the trial court that the absence of any language in the Lease identifying an address to which a certified letter could be delivered excused Lessor from sending written notice by certified mail.

Nevertheless, it appears that Lessee had notice of Lessor's declaration of default. Mr. Michael Andrews, former president and member of the board of directors for Lessee, spoke with Lessor in January 2007 about Lessee's default under the Lease. Mr. Andrews testified that he learned of the default through a telephone conversation with Lessor. Mr. Andrews stated:

> And I called Mr. Howard [Lessor] in early 2007 to let him know that I had an individual coming out to give me a quotation on site preparation for the drilling of the #3 well. And that was the time he directly informed me that he considered the [L]ease not [to] be valid any longer.

Along with Mr. Andrews's testimony, the record contains a letter written by Timothy Cook, president and member of the board for Lessee, dated February 19, 2007. The letter was addressed to Lessor, and in the letter, Lessee explained that the well was "still active" and promises to "continue to send you [Lessor] a check for $163.00 per month until this issue is resolved." Mr. Cook enclosed a check for $815.00 because "the well shut-in due to Citizens Gas stopping all production in the area."

In light of the above proof, the evidence does not preponderate against the trial court's determination that Lessor gave notice of the default. In fact, like the trial court, we find that there was notice of default in early January 2007, but the attempt to cure – the delivery of the check on February 19, 2007 – fell outside of the ten-day period to cure as provided for in the Lease. As a result, Lessee's assertions regarding Lessor's failure to provide notice of default are without merit.

Lessee next asserts that it complied with the "shut-in" royalty provision of the Lease, thereby keeping the Lease in effect. Lessee cites paragraph three of the Lease, which states:

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[4]In August 2004, Lessee compensated attorney Frank Wilson to prepare the Lease with Lessor for the property at issue. Mr. Wilson subsequently prepared the lease between Montello and Lessor. He then appeared as counsel for Lessor in this case, but was replaced in recognition of the conflict of interest.

> 3. SHUT IN WELLS: Shut in gas wells shall be considered the same as wells producing in paying quantities whether during or after the primary term hereof so long as the Lessee pays to the Lessors as royalty the sum of $1 per net royalty acre retained hereunder per year. Payment shall be tendered as set forth herein.

According to Lessee, "payment shall be tendered as set forth herein" refers to paragraph two of the Lease, which provides:

> 2. DRY HOLES: Lessor agrees that if Lessee drills a dry hole on the leased premises or upon any pooled unit which contains a part of the leased premises, then the term of this lease shall be extended or the payment of rentals due herein shall be excused for a period of one year from the date drilling ceases on said well, and the Lessee shall either commence the drilling of another well before the end of said period or commence paying rentals as provided herein. If a well capable of producing oil or gas is drilled under this provision, Lessee shall be able to continue this lease by making the rental or royalty payments set out herein.

Lessee argues that paragraph three requires that the shut-in royalty payment be tendered to Lessor within one year from the date that the well was shut in. Citizens Gas ceased production of the well in August 2006, and the $815 payment was made to Lessor in February 2007, which was within the one-year period. Lessee also claims that it was only obligated to pay $248 to keep the Lease in effect, but paid $815 as a sign of good faith.

In Tennessee, the term "production" means "production in paying quantities" as used in the context of an oil and gas lease. *Waddle*, 551 S.W.2d at 326; *see also Groce*, 792 S.W.2d at 721. Generally, oil and gas leases "terminate at the end of the primary term unless there is production." *Slaven*, 754 S.W.2d at 66. Thus, shut-in provisions permit lessees "to keep the lease alive by paying a fixed money royalty even though gas is not being produced." *Id.*; *Young*, 647 S.W.2d at 237.

Although Lessee cites *Slaven* and *Young* in support of its position, the facts from those cases are distinguishable from the present case. As stated in *Slaven*, "[t]he shut-in royalty clause must be considered in light of the remainder of the lease." 754 S.W.2d at 66. The leases at issue in *Slaven* and *Young* contained shut-in provisions that specified that the royalty payments were to be paid at the "end of each yearly period." *Slaven*, 754 S.W.2d at 66; *Young*, 647 S.W.2d at 236. Additionally, this court found in both *Slaven* and *Young* that the lessees attempted to create producing wells during the primary term of the leases at issue by

undertaking and continuing diligently with drilling and operations. *See Slaven*, 754 S.W.2d at 66; *Young*, 647 S.W.2d at 237.

In the instant case, Lessee did not attempt any drilling or other operations to cause production in the well before the expiration of the primary term. Further, Lessee failed to specify in the Lease when shut-in royalty payments were due. Although Lessee encourages this court to read the Lease to require tendering a shut-in royalty payment within one year of the well becoming shut-in, the language of the Lease does not support such an interpretation. In fact, there is no such language in paragraph three. Lessee claims that such an interpretation of the Lease is valid in light of paragraph two, the dry holes provision. Again, we do not agree.

The one year time period set out in the dry holes provision only comes into effect when and if "Lessee drills a dry hole." The dry holes provision is irrelevant to the current dispute because a dry hole was not drilled in the instant case. Therefore, we agree with the trial court that "there was no well capable of producing oil and gas drilled under this [dry holes] provision of the contract." The Lease failed to include any specific time when royalty payments become due. Because of this absence, the trial court determined that ". . .shut-in royalties, were due month by month, and that is the reasonable interpretation of the contract [Lease] in the absence of a time period other than that."

Nothing in the record preponderates against the trial court's reasonable interpretation of the Lease. We construe this uncertain term against Lessee and find that the shut-in royalty payments were due monthly. As a result, the shut-in royalty payment of $815 was untimely as it was tendered in February 2007, approximately five months after the well became shut-in. Therefore, we affirm and hold that the Lease terminated because Lessee did not tender payment within one month of the well's halt in production.

Lastly, Lessee argues that this court should consider that it has acted in good faith when construing the Lease. In *Waddle*, the Court stated that it is appropriate for courts to consider the "good faith effort by the lessee" and other "equitable considerations." 551 S.W.2d at 326. Lessee maintains that it acted in good faith in all its dealings with Lessor, which is evidenced by its attempts to reason with Lessor and the $815 shut-in royalty payment. Lessee highlights that the $815 royalty payment was more than three times the required amount to keep the Lease in effect.

We are not persuaded by Lessee's argument; we do not find that equitable considerations tip in favor of Lessee. We agree, as Lessor claims, that Lessee knew that the well was not producing gas, but waited four months before initiating communication with Lessor. Lessee had a good faith obligation to either drill wells, maintain the well's

production, or tender timely shut-in royalty payments. Despite its superior position of knowledge, Lessee failed to act pursuant to the terms of the Lease. Courts interpret contracts according to "the usual, natural, and ordinary meaning of the language used." *See Seraphine v. Aqua Bath Co.*, M2000-02662-COA-R3-CV, 2003 WL 1610871, at *3 (Tenn. Ct. App. M.S., Mar. 28, 2003) (citations omitted). We construe any provisions of the Lease that are "ambiguous or vague against the party responsible for drafting them." *See id.*, at *4; *see also Hanover Ins. Co. v. Haney*, 425 S.W.2d 590, 592 (Tenn. 1968); *Realty Shop, Inc. v. RR Westminster Holding, Inc.*, 7 S.W.3d 581, 598 (Tenn. Ct. App. 1999). Lessee was the more sophisticated party and drafter of the Lease, and therefore, we will not ignore the terms or interpret the vague terms of the Lease in favor of Lessee's position.

CONCLUSION

Accordingly, we conclude that the Lease expired by its own terms because Lessee failed to produce oil or gas from the well or tender rental or royalty payments to Lessor for four months. Once the Lease expired by its own terms, Lessor was not obligated to provide written notice of default to Lessee. Lessee's subsequent payment of $815 for shut-in royalties was untimely, and Lessor's return of the payment illustrates his understanding that the Lease had terminated. Therefore, we affirm the trial court's determination that the Lease terminated one month after the well ceased gas production.

The judgment of the trial court is affirmed in its entirety. Costs are assessed against the Appellant, Lone Star Oil & Gas, Inc. The case is remanded, pursuant to applicable law, for enforcement of the trial court's judgment and for collection of costs assessed below.

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JOHN W. McCLARTY, JUDGE